

**Office of Chief Counsel
Internal Revenue Service
memorandum**

CC:TEGE:EOEG:ET1:LMDonis
PRES-116376-09

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Director
IRS HSPD-12 Project Management Office

from: Janine Cook
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subject: PRES-116376-09: Reimbursement of HSPD-12 Expenses

This memorandum responds to your request for assistance.

ISSUE

Whether amounts paid to employees as reimbursement for expenses incurred to obtain required forms of identification or changes to current identification pursuant to Homeland Security Presidential Directive-12 (HSPD-12) are taxable wages to the employees.

CONCLUSION

Amounts paid to employees as reimbursement for expenses incurred to obtain identification cards are deductible employee business expenses under section 162 of the Internal Revenue Code, and thus are excluded from income and wages if made under an accountable plan.

BACKGROUND

HSPD-12 was issued on August 27, 2004 to address post September 11, 2001 concerns regarding terrorism and the internal security of government facilities and data. The initiative's goal is to standardize Federal government identification cards and processes so that government employees have secure and reliable forms of identification in order to increase the security of Federal facilities and Federal

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Information Technology Systems and provide better protection for employees, the information systems, and the employees' work products. Pursuant to HSPD-12, all applicable IRS employees and contractors are required to obtain new identification cards.

In order to obtain new identification cards, IRS employees and contractors are required to validate their identity and are required to present both primary and secondary forms of identification.

Acceptable primary forms of identification are:

- U.S. Passport
- Driver's license or ID card issued by a state or possession of the U.S. (provided it contains a photograph),
- U.S. Military ID card,
- U.S. Military Dependant's ID card, and
- Department of Defense Common Access Card.

Acceptable forms of secondary identification include:

- U.S. Social Security Card
- Original or certified copy of birth certificate
- ID card issued by federal, state, or local government agencies or entities (provided it contains a photograph)
- School ID with photograph
- Voter's registration card

Employees are required to provide at least one form of primary identification and one form of secondary identification. Name information on the forms of identification must match, otherwise enrollment will be denied.

DISCUSSION

Question 1: Are the costs incurred by current employees to satisfy the requirements of HSPD-12 employee business expenses under section 162 of the Internal Revenue Code?

Section 162(a) of the Internal Revenue Code allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Whether an expense is ordinary and necessary is a question of fact.

Commissioner v. Heining, 320 U.S. 467, 475 (1943). In general, a trade or business expense is ordinary if it is normal, usual, or customary in the taxpayer's type of business. *Deputy v. du Pont*, 308 U.S. 488, 495 (1940).

Being an employee constitutes a trade or business for purposes of section 162(a). *Primuth v. Commissioner*, 54 T.C. 374 (1970), acq. in result on another issue, 1972-2 C.B. 2, (1972); *Gordeon El v. Commissioner*, T.C. Memo 1990-182, aff'd without op.,

980 F.2d 723 (3rd Cir. 1992).

Section 262 of the Code provides that no deduction shall be allowed for personal, living or family expenses, except as otherwise provided in the Code. “The fact that a particular expense may under certain circumstances be a nondeductible personal expense does not preclude the deduction of such an expense as an ordinary and necessary business expense under other circumstances.” Rev. Rul. 75-316, 1975-2 C.B. 54.

Expenditures, even ones that seem to be personal, can be deductible if they are required by the employer and are related to the job. In *Sibla v. Commissioner*, 611 F.2d 1260 (9th Cir. 1980), acq. in part 1978-2 C.B. 2, nonacq. in part, 1978-2 C.B. 4, nonacq. withdrawn and acq. in part, 1985-2 C.B. viii (1985), a fireman could deduct his share of the cost of a mandatory organized mess at the firehouse. The city had mandated that each fireman participate as a condition of employment in the organized mess due to a city-wide desegregation policy. The court stated that when conditions of employment restrict an employee’s discretion in typically personal choices, “that which may be a personal expense under some circumstances prescribed by company regulations, directives and conditions, lose its character as a personal expense and take on the color of a business expense.” *Id.* at 1262.

In *Christey v. Commissioner*, 841 F.2d 809 (8th Cir. 1988), cert. denied, 489 U.S. 1016 (1989), the court allowed police officers to deduct the cost of meals consumed while on duty when the city mandated the particular restaurant, location and time when the officer could eat. The court in *Pollei v. Commissioner*, 877 F.2d 838 (10th Cir. 1989), held that on duty police chiefs could deduct the cost of commuting to and from the station when the city mandated that the chiefs were on duty from the moment they left their residence until they returned and retrofitted the chiefs’ personal cars for police purposes.

In the above cases, the courts found the expenses deductible because they related to the taxpayers’ performance of their jobs and were required by the employer. In each case, the court emphasized the unique situations that compelled the characterization of a traditionally personal expense as a business expense.

In the present case, the IRS mandated that each employee have a new identification card for homeland security purposes. The identification card is required by the employer and is related to the employee’s employment. In order to obtain the required identification card, some employees may have to incur preliminary expenses to validate their identity. In most circumstances, the costs incurred to establish identification would be a personal expense; however, here, the IRS has established procedures that the employee must follow in order to obtain the required identification card. Under such circumstances, these costs incurred by the employees at the direction and mandate of the IRS are appropriately characterized as a business expense, rather than personal expense.

Consequently, the costs incurred by employees for required identification in order to obtain the HSPD-12 identification card required by the IRS are deductible employee business expenses under section 162(a) of the Code.

Question 2: When the employee business expenses are reimbursed by the employer, is the reimbursement excluded from income and wages?

Section 61 of the Internal Revenue Code (Code) defines gross income as all income, from whatever source derived. Section 62 defines adjusted gross income as gross income minus certain deductions. Section 62(a)(2)(A) provides that, for purposes of determining adjusted gross income, an employee may deduct certain business expenses paid by the employee in connection with the performance of services as an employee of the employer under a reimbursement or other expense allowance arrangement.

Section 62(c) provides that, for purposes of § 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if (1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or (2) the arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 1.62-2(c)(1) of the Income Tax Regulations provides that a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses.¹ If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. See § 1.62-2(c)(2). Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. See § 1.62-(2)(c)(4). Conversely, if the arrangement fails any one of these requirements, amounts paid under the arrangement are treated as paid under a nonaccountable plan and are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See § 1.62-2(c)(3) and (5).

An arrangement meets the business connection requirement of §1.62-2(d) if it provides advances, allowances, or reimbursements for business expenses that are allowable as deductions by Part VI (section 161 and the following), subchapter B, Chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer.

¹ It is important to note that the term "arrangement" does not require a formal plan document.

Section 1.62-2(e)(1) provides that the substantiation requirement is met if the arrangement requires each business expense to be substantiated in accordance with paragraph (e)(2) or (e)(3) of that section, whichever is applicable, to the payor (the employer, its agent or a third party) within a reasonable period of time. Section 1.62-2(g)(1) provides that what constitutes a reasonable period of time depends on the facts and circumstances of each arrangement. However, § 1.62-2(g)(2) provides a safe harbor for substantiation under which the substantiation requirement is met if an expense is substantiated within 60 days after the expense is paid or incurred.

Section 1.62-2(e)(3) provides that an arrangement that reimburses business expenses not governed by § 274(d) meets the requirements of § 1.62-2(e)(3) if information is submitted to the payor sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities. Each of the elements of an expenditure or use must be substantiated to the payor, and it is not sufficient for an employee to merely aggregate expenses into broad categories or to report individual expenses through the use of vague, non-descriptive terms.

Section 1.62-2(e)(3) references §1.162-17(b) which provides substantiation rules for employee business expenses. Section 1.162-17(b)(1) Section 1.162-17(b) provides that an employee is not required to report on his tax return expenses paid or incurred solely for the benefit of his employer for which he is required to account and does account to his employer and which are charged directly or indirectly to the employer or for which the employee is paid through advances, reimbursements, or otherwise, provided the total amount of such advances, reimbursement, and charges is equal to such expenses. Section 1.162-17(b)(4) requires an employee to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses.

Section 1.62-2(f) provides that, in general, an arrangement meets the requirement of returning amounts in excess of expenses if it requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated. Section 1.62-2(g)(2) provides a safe harbor for return of excess under which the return of excess requirement is met if an amount is returned to the payor within 120 days after an expense is paid or incurred. An arrangement will not meet the return of excess requirement if it fails to satisfy the substantiation requirement under §1.62-2(e) since any amounts paid under the arrangement that are not substantiated are treated as excess and must be returned.

In the present case, employees will be reimbursed for expenses incurred to obtain identification cards required for employment. As discussed above, these expenses are deductible business expenses so that an arrangement providing for the reimbursement of only such expenses satisfies the business connection requirement of an accountable

plan.

If the arrangement requires the employee to account, and the employee does account, for the amount and business nature of the expense incurred within a reasonable period of time after the expense is paid or incurred, the arrangement will satisfy the substantiation requirement of an accountable plan. As noted above, a requirement to substantiate within 60 days of incurring the expense is deemed to be a reasonable period of time.

If the arrangement requires the employee to return any reimbursement in excess of the substantiated expenses within a reasonable period of time, the arrangement will satisfy the return of excess requirement of an accountable plan. If an arrangement does not provide any advances, the requirement to return excess applies to reimbursements made in error. As noted above, a requirement to return excess within 120 days of substantiating the expense is deemed to be a reasonable period of time.

Since the arrangement to reimburse the HSPD-12 expenses satisfies the business connection requirement, if it also satisfies the substantiation and return of excess requirements, reimbursements made under the arrangement will be treated as made under an accountable plan and will be excluded from the employees' income and wages.

Please call Ligeia Donis at (202) 622-0047 for questions regarding the accountable plan rules or Erika Reigle at (202) 622-4950 for questions regarding deductibility under section 162.